



**REPORT OF THE AUDITOR OF PUBLIC ACCOUNTS  
AUDIT EXAMINATION OF THE  
KENTUCKY LOTTERY CORPORATION**

**Fiscal Year Ended June 30, 2001 and 2000**

**EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS  
[WWW.KYAUDITOR.NET](http://WWW.KYAUDITOR.NET)**

**144 CAPITOL ANNEX  
FRANKFORT, KY 40601  
TELE. (502) 564-5841  
FAX (502) 564-2912**





EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS

December 10, 2001

To the People of Kentucky

Honorable Paul E. Patton, Governor

Honorable David L. Williams, President, Kentucky Senate

Honorable Jody Richards, Speaker, Kentucky House of Representatives

Board of Directors, Kentucky Lottery Corporation

As Auditor of Public Accounts, I am pleased to transmit herewith the thirteenth full financial and compliance audit of the books and records of the Kentucky Lottery Corporation (Corporation) as required by KRS 154A.130.

The audit was performed by the independent accounting firm of Potter and Company, L.L.P. (firm), in accordance with generally accepted government auditing standards. The audit included the balance sheets as of June 30, 2001 and 2000, the related statements of revenues, expenses, and changes in retained earnings and cash flows for the years then ended, notes to the financial statements, and a report on compliance and internal controls, together with comments and recommendations on the Corporation's internal control.

The firm's report on the financial and compliance audit is attached and is summarized as follows:

- 1) The Corporation's financial statements are presented fairly in all material respects.
- 2) At June 30, 2001, the Corporation's assets totalled \$322,856,000; a decrease of \$55,351,000 over June 30, 2000.

Significant changes in assets from the prior year included:

- Decrease in total investments (current and long-term) of \$52,541,000

To the People of Kentucky

Honorable Paul E. Patton, Governor

Honorable David L. Williams, President, Kentucky Senate

Honorable Jody Richards, Speaker, Kentucky House of Representatives

Board of Directors, Kentucky Lottery Corporation

- 3) At June 30, 2001, the Corporation's liabilities and equity totaled \$322,856,000, a decrease of \$55,351,000 over June 30, 2000.

Significant changes in liabilities and equity from the prior year included:

- Decrease in notes payable, less current portion of \$1,358,000;
- Decrease in total estimated prize liability (current and long-term) of \$54,549,000;
- Increase in retained earnings of \$781,000.

- 4) Significant items concerning the statements of revenue, expenses and changes in retained earnings for the year ended June 30, 2001, included:

- Gross profit was \$198,109,000; a decrease of \$2,074,000 over 2000.
- Operating expenses increased \$1,612,000 over 2000.
- Net income before transfer of dividends to the Commonwealth increased \$3,967,000 over 2000.
- Dividends to the Commonwealth were \$159,145,000; a decrease of \$3,060,000 over 2000. The dividends included a transfer of \$5,145,000 to the Affordable Housing Trust Fund from uncollected prize winnings.
- Net income was \$781,000; an increase of \$7,027,000 compared to net loss for 2000.
- Retained earnings were \$46,534,000; an increase of \$781,000 over 2000.

- 5) Significant items concerning the statement of cash flows for the year ended June 30, 2001, included:

- Net cash provided by operating activities decreased \$42,410,000 over 2000.
- Net cash used in noncapital financing activities decreased \$2,300,000 over 2000.
- Net cash used in capital and related financing activities decreased \$394,000 over 2000.
- Net cash provided by investing activities increased \$30,062,000 over 2000.

To the People of Kentucky

Honorable Paul E. Patton, Governor

Honorable David L. Williams, President, Kentucky Senate

Honorable Jody Richards, Speaker, Kentucky House of Representatives

Board of Directors, Kentucky Lottery Corporation

- 6) As discussed in Note 4, the Corporation has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this Statement requires investments to be presented at fair value. In prior years, investments were reported at cost and adjusted for the accretion of interest based upon the purchased yield and maturity date. When compared to the historical cost method, this results in additional income of approximately \$1,099,000 in 2001 and additional loss of approximately \$6,246,000 in 2000.
- 7) As discussed in Note 13, the Corporation has approved revisions to the Corporation's Rules and Regulations of the "special claim period" for claimants of qualified prizes to exercise an option to receive the lump-sum cash value equivalency of their remaining annuitized prizes. This option allows pre-October 22, 1998 winners, to elect a single cash payment of the remaining value of their prize within an 18-month period. This option period covers fiscal years ending June 30, 2000 and June 30, 2001. The Corporation recorded a loss of \$4,964,000 and \$7,616,000 on these single cash payments in fiscal year 2000 and 2001 respectfully. There were 189 prize winners eligible for this option; 38 winners exercised their option in fiscal year ending 2000 and 44 winners exercised their option in fiscal year ending 2001.
- 8) The Corporation defines gross revenues as total sales. For the year ended June 30, 2001, these totaled \$590,851,000. Dividends paid to the Commonwealth totaled \$154,000,000 or 26.1 percent of total sales.

KRS 154A.130 states the intent of the Legislature regarding dividends paid to the Commonwealth:

After the start-up costs are paid, it is the intent of the Legislature that it shall be the goal of the Corporation to transfer each year thirty-five percent (35%) of gross revenues to the general fund . . .

The Corporation did not meet this goal, since only 26.1 percent of total sales were transferred to the Commonwealth. The goal based on total sales of \$590,851,000 would have been \$206,797,850. This is a shortfall of \$52,797,850 of the goal.

- 9) The Corporation's financial statements will be included in the Commonwealth of Kentucky's Comprehensive Annual Financial Report for the year ended June 30, 2001.
- 10) The firm tested the Corporation's compliance with certain provisions of laws, regulations, contracts, and grants. While not giving an opinion on the Corporation's overall compliance with such provisions, the firm did state that the results of their tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

To the People of Kentucky

Honorable Paul E. Patton, Governor

Honorable David L. Williams, President, Kentucky Senate

Honorable Jody Richards, Speaker, Kentucky House of Representatives

Board of Directors, Kentucky Lottery Corporation

- 11) The firm considered the Corporation's internal control over financial reporting in order to determine auditing procedures for the purpose of expressing an opinion on the financial statements, not to provide assurance on the internal control over financial reporting. The firm noted no material weaknesses involving the internal control over financial reporting.

The Corporation has entered into an agreement with the public accounting firm of Crowe Chizek to perform the function of "drawing auditor" for the computer on-line games operated by the Corporation during the year ended June 30, 2001. Quarterly reports on the results of the drawing observations and certifications are made by Crowe Chizek for the on-line games. In addition, Crowe Chizek observes and reports on the procedures used to certify the lotto balls used in all games. All reports are available for review in the Office of the Auditor of Public Accounts.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Ed Hatchett", with a long horizontal flourish extending to the right.

Edward B. Hatchett, Jr.

Auditor of Public Accounts

KENTUCKY LOTTERY CORPORATION  
FINANCIAL STATEMENTS AND  
INDEPENDENT AUDITOR'S REPORT  
JUNE 30, 2001 AND 2000



## C O N T E N T S

	<u>Page</u>
Independent Auditor's Report	1
Financial Statements:	
Balance Sheets	2
Statements of Revenues, Expenses and Changes in Retained Earnings	3
Statements of Cash Flows	4-5
Notes to Financial Statements	6-14
Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards	15
Schedule of Findings	16
Schedule of Prior Audit Findings and Their Resolutions	17



## INDEPENDENT AUDITOR'S REPORT

To the Auditor of Public Accounts, Commonwealth of Kentucky and  
the Board of Directors, Kentucky Lottery Corporation

We have audited the accompanying financial statements of the Kentucky Lottery Corporation (the Corporation) as of June 30, 2001 as listed in the table of contents. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying financial statements of the Kentucky Lottery Corporation as of June 30, 2000, were audited by other auditors whose report dated August 2, 2000, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Kentucky Lottery Corporation as of June 30, 2001, and the results of its operations and its cash flows in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 10, 2001 on our consideration of the Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.



POTTER & COMPANY, LLP  
August 10, 2001



KENTUCKY LOTTERY CORPORATION  
BALANCE SHEETS  
June 30, 2001 and 2000  
(dollars in thousands)

A S S E T S

	<u>2001</u>	<u>2000</u>
Current assets:		
Cash and equivalents	\$ 27,221	\$ 29,793
Investments at fair value, current portion	27,615	34,047
Accounts receivable, net	21,149	19,477
Ticket inventories	340	385
Deposits with Commonwealth of Kentucky	0	487
Other	<u>688</u>	<u>349</u>
Total current assets	77,013	84,538
Investments at fair value, less current portion	231,000	277,109
Property and equipment, net	11,213	12,769
Deposits with Multi-State Lottery Association	<u>3,630</u>	<u>3,791</u>
Total assets	<u>\$ 322,856</u>	<u>\$ 378,207</u>

L I A B I L I T I E S   A N D   E Q U I T Y

Current liabilities:		
Accounts payable and accrued expenses	\$ 6,140	\$ 5,605
Dividends payable	5,145	5,905
Notes payable, current portion	1,356	1,356
Estimated prize liability, current portion	<u>45,261</u>	<u>52,621</u>
Total current liabilities	57,902	65,487
Notes payable, less current portion	341	1,699
Estimated prize liability, less current portion	<u>217,979</u>	<u>265,168</u>
Total liabilities	<u>276,222</u>	<u>332,354</u>
Equity:		
Contributed capital	100	100
Retained earnings	<u>46,534</u>	<u>45,753</u>
Total equity	<u>46,634</u>	<u>45,853</u>
Total liabilities and equity	<u>\$ 322,856</u>	<u>\$ 378,207</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS  
for the years ended June 30, 2001 and 2000  
(dollars in thousands)

	2001	2000
Sales:		
Instant games	\$ 305,602	\$ 297,729
On-line games	285,249	285,949
Total sales	<u>590,851</u>	<u>583,678</u>
Direct costs:		
Commissions to retailers	36,344	35,256
Prize expense:		
Instant games	197,884	191,920
On-line games	151,936	150,005
Total prize expense	<u>349,820</u>	<u>341,925</u>
Ticket costs	6,578	6,314
Total direct costs	<u>392,742</u>	<u>383,495</u>
Gross profit	<u>198,109</u>	<u>200,183</u>
Operating expenses:		
Advertising and promotion	10,183	8,127
Salaries, wages and benefits	10,990	10,862
Contracted and professional services	11,454	12,598
Depreciation	3,207	3,141
Other general and administrative	5,806	5,300
Total operating expenses	<u>41,640</u>	<u>40,028</u>
Operating income	<u>156,469</u>	<u>160,155</u>
Nonoperating income (expense):		
Investment income	32,469	13,392
Loss on single cash payments – Note 13	(7,616)	(4,964)
Interest expense	(21,646)	(12,883)
Other income	250	258
Total nonoperating income (expense)	<u>3,457</u>	<u>(4,196)</u>
Net income before dividends paid	159,926	155,959
Dividends paid	<u>159,145</u>	<u>162,205</u>
Net income (loss)	781	(6,246)
Retained earnings, beginning of year	<u>45,753</u>	<u>51,999</u>
Retained earnings, end of year	<u>\$ 46,534</u>	<u>\$ 45,753</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF CASH FLOWS  
for the years ended June 30, 2001 and 2000  
(dollars in thousands)

	2001	2000
Cash flows from operating activities:		
Cash received from customers	\$ 589,356	\$ 592,690
Cash payments to suppliers for goods and services	(503,107)	(464,159)
Cash payments to employees for services	(10,990)	(10,862)
	<u>75,259</u>	<u>117,669</u>
Net cash provided by operating activities		
Cash flows from noncapital financing activities:		
Dividends paid	(159,905)	(162,205)
	<u>(159,905)</u>	<u>(162,205)</u>
Cash flows from capital and related financing activities:		
Purchases of property and equipment, net	(1,658)	(1,862)
Proceeds from disposal of equipment	98	0
Repayments of long-term debt	(1,356)	(1,356)
Interest expense	(165)	(257)
	<u>(3,081)</u>	<u>(3,475)</u>
Net cash used in capital and related financing activities		
Cash flows from investing activities:		
Proceeds from sale of investments	87,132	61,663
Purchase of investments	(4,431)	(8,562)
Deposits with Multi-State Lottery Association	161	(56)
Investment income	2,293	2,048
	<u>85,155</u>	<u>55,093</u>
Net cash provided by investing activities		
Net increase (decrease) in cash and equivalents	(2,572)	7,082
Cash and equivalents at beginning of year	29,793	22,711
	<u>29,793</u>	<u>22,711</u>
Cash and equivalents at end of year	<u>\$ 27,221</u>	<u>\$ 29,793</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF CASH FLOWS  
for the years ended June 30, 2001 and 2000  
(dollars in thousands)

	<u>2001</u>	<u>2000</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	<u>\$ 156,469</u>	<u>\$ 160,155</u>
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	3,207	3,141
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	(1,672)	8,857
Ticket inventories	45	(113)
Deposits with Commonwealth of Kentucky	487	0
Other assets	(339)	(41)
Accounts payable and accrued expenses	535	(4,080)
Dividends payable	(760)	2,418
Estimated prize liability	<u>(82,713)</u>	<u>(52,668)</u>
Total adjustments	<u>(81,210)</u>	<u>(42,486)</u>
Net cash provided by operating activities	<u><u>\$ 75,259</u></u>	<u><u>\$ 117,669</u></u>

Noncash investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability, totaled \$21,481 and \$12,626 for the years ended June 30, 2001 and 2000, respectively.

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 1 - ORGANIZATION

The Kentucky Lottery Corporation (the Corporation) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). The Corporation is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the Corporation are separate and distinct from other operations of the Commonwealth.

The Corporation commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the Corporation joined the Multi-State Lottery Association, a group of states that combine lottery sales for on-line games.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity:

The Corporation has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, "The Financial Reporting Entity," under which the financial statements include all the organizations, activities, functions and component units for which the Corporation is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's board, and either (1) the Corporation's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the Corporation.

The Corporation has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the Corporation's financial statements. In addition, since the Corporation provides a financial benefit for the Commonwealth, the Corporation is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Annual Financial Report.

Basis of Presentation:

The Corporation is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with generally accepted accounting principles. The Corporation has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Corporation has further elected not to apply FASB pronouncements issued after November 30, 1989.

Revenue and Accounts Receivable Recognition:

Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant scratch games are recognized upon activation of tickets for sale by the retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowance for Doubtful Accounts:

The Corporation uses the allowance method to account for uncollectible accounts receivable.

Prizes:

Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure.

Grand prizes are awarded related to the Lotto Kentucky and Powerball on-line games. Lotto Kentucky grand prizes are paid in twenty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty annual payments. For Lotto Kentucky winners electing annual installments, the actual prize expense is the cost of the U.S. Treasury zero coupon bonds which the Corporation purchases to fund the annual payments. For Lotto Kentucky winners electing present cash value, the actual prize expense is the lump-sum payment equal to the cost of U.S. Treasury zero coupon bonds, priced seven days prior to the draw date, as if the Corporation was to fund twenty equal annual installments.

Powerball grand prizes are paid in twenty-five equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty-five annual payments, except for payments made to winners under the single cash payment prize option described in Note 13. The Corporation recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the Corporation is remitted to the Multi-State Lottery Association (MUSL) to fund prize payments. MUSL purchases U.S. Government agency securities to fund prize liability to Powerball winners electing annual installments.

Cash and Equivalents:

For financial statement purposes, the Corporation considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Investments:

Investments consist of U.S. Treasury zero coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools." Fair value of investments is based on quoted market prices.

Ticket Inventories:

Inventories are carried at cost (as determined by the specific identification method) and consist of pull-tab tickets located in the Corporation's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Property and Equipment:

Property and equipment are carried at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated lives of three to thirty years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over lease terms of three to five years.

Deposits with Multi-State Lottery Association (MUSL):

Deposits are carried at cost. MUSL is an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games. MUSL currently includes 20 state lottery entities and the District of Columbia and sells three games known as Powerball, Wild Cash and Cash 4 Life. The chief executive officer of each member lottery serves on the MUSL board of directors. As a member of MUSL, the Corporation is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All prize reserve funds remitted, and the related interest earnings, will be returned to the Corporation upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

Estimated Prize Liability:

A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the balance sheet net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

Dividends Payable:

A liability for dividends payable results from dividends payable to either the Commonwealth's general fund or to the Affordable Housing Trust Fund. The dividends payable to the Affordable Housing Trust Fund result from unclaimed prizes on instant and on-line games. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the Corporation and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the Corporation for any public purpose. Any unclaimed prize money in excess of \$6,000,000 per fiscal year is transferred to the Affordable Housing Trust Fund, as required by KRS section 154A.110(3). Payments are made as necessary during January and July of each fiscal year, depending on the volume of unclaimed prizes.

Dividends Paid:

Dividends paid represent a transfer of funds from the Corporation to the Commonwealth's general fund and the Affordable Housing Trust Fund. The dividends paid to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The dividends paid to the Affordable Housing Trust Fund are used to address the critical housing needs of extremely low income Kentuckians.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Use of Estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

NOTE 3 - CASH AND EQUIVALENTS

Cash and equivalents include amounts held in bank accounts with book overdrafts of approximately \$406,000 and bank balances of approximately \$151,000 at June 30, 2001. Such balances are fully covered by federal depository insurance. Also included in cash and equivalents at June 30, 2001 are overnight repurchase agreements of \$27,478,000 which are classified as Category 1 investments. The Corporation's investments are categorized to give an indication of the level of credit risk assumed by the Corporation at year-end. Category 1 is comprised of investments that are either insured or registered, or for which the securities are held by the Corporation's agent in the Corporation's name.

NOTE 4 - INVESTMENTS

The Corporation has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this statement requires investments to be presented at fair value. When compared to the historical cost method, this results in additional income of approximately \$1,099,000 in 2001 and additional loss of approximately \$6,246,000 in 2000.

Retained earnings at June 30 consisted of (in thousands):

	2001	2000
Retained earnings excluding unrealized gains on investments	\$ 31,670	\$ 31,988
Unrealized gains on investments	14,864	13,765
	<u>\$ 46,534</u>	<u>\$ 45,753</u>

The net increase in the fair value of investments includes all changes in fair value (including purchases and sales) that occurred during the year. The components of investment income for the years ended June 30, 2001 and 2000 consisted of the following (in thousands):

	2001	2000
Net increase in fair value of investments	\$ 30,175	\$ 11,344
Interest income	2,216	1,964
Security lending income	78	84
Total investment income	<u>\$ 32,469</u>	<u>\$ 13,392</u>

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 4 – INVESTMENTS (CONTINUED)

All investments held at June 30, 2001 and 2000 were in Category 1 and were held in U.S. Treasury zero coupon bonds and other U.S. Government agency securities.

Grand prize investments at June 30, 2001 and 2000 consisted of the following (in thousands):

	2001	2000
Direct U.S. Treasury Investments	\$ 122,212	\$ 57,290
Other U.S. Governmental Agency Securities	136,403	253,866
	<u>\$ 258,615</u>	<u>\$ 311,156</u>

The Corporation is authorized by state statutes and investment policies approved by the Board of Directors to lend its investment securities. The lending is managed by the Corporation's custodial bank. All loans can be terminated on demand by either the Corporation or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the Corporation's securities.

The custodial bank lends the Corporation's U.S. Treasury zero coupon bonds and other U.S. Government agency securities for securities collateral of 102 percent. The securities lending contracts do not allow the Corporation to pledge or sell any collateral securities unless the borrower defaults. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

At June 30, 2001 and 2000, the Corporation had loaned investments with fair values of approximately \$42,956,000 and \$68,177,000, respectively, to authorized brokers for a fee. In exchange for the loaned investments, the Corporation has temporarily received direct obligations of the U.S. Treasury and securities issued by U.S. Government agencies with fair values of approximately \$57,523,000 and \$69,541,000 at June 30, 2001 and 2000, respectively, which are held by the Corporation's custodial bank in the Corporation's name. The Corporation's loaned investments are included in the investments reported in the financial statements rather than the securities received in the exchange.

The lending agent provides indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fail to pay income distributions on them. There were no violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent. All borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 5 - ACCOUNTS RECEIVABLE

Accounts receivable at June 30 consisted of the following (in thousands):

	2001	2000
Accounts receivable	\$ 21,473	\$ 20,003
Allowance for doubtful accounts	(324)	(526)
Accounts receivable, net	<u>\$ 21,149</u>	<u>\$ 19,477</u>

NOTE 6 - PROPERTY AND EQUIPMENT

Property and equipment at June 30 consisted of the following (in thousands):

	2001	2000
Buildings	\$ 7,142	\$ 7,129
Land	423	423
Leasehold improvements	327	327
Game equipment	9,899	9,389
Data processing equipment	14,588	13,935
Automobiles, furniture and fixtures	3,453	3,232
	35,832	34,435
Accumulated depreciation	(24,619)	(21,666)
Property and equipment, net	<u>\$ 11,213</u>	<u>\$ 12,769</u>

NOTE 7 - NOTES PAYABLE

On December 18, 1996, the Corporation borrowed \$6,787,000 to fund the renovation of real estate purchased during the year ended June 30, 1996 to be used as new corporate headquarters. The terms of the loan require monthly interest payments beginning December 31, 1996 with an annual interest rate of 6.66%. Principal payments began in October 1997 and are due in 60 monthly installments.

Scheduled maturities of the Corporation's notes payable are as follows (in thousands):

2002	\$ 1,356
2003	341
	<u>\$ 1,697</u>

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 8 - ESTIMATED PRIZE LIABILITY

Estimated prize liability at June 30 consisted of the following (in thousands):

	<u>2001</u>	<u>2000</u>
Current:		
Grand prizes	\$ 27,615	\$ 34,047
Other prizes	<u>17,646</u>	<u>18,574</u>
	<u>\$ 45,261</u>	<u>\$ 52,621</u>
Long-term:		
Grand prizes	\$ 338,545	\$ 434,154
Less imputed interest	<u>(120,566)</u>	<u>(168,986)</u>
	<u>\$ 217,979</u>	<u>\$ 265,168</u>

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately \$21,481,000 and \$12,626,000 in 2001 and 2000, respectively, is included in interest expense. Interest expense for the years ended June 30, 2001 and 2000 consisted of (in thousands):

	<u>2001</u>	<u>2000</u>
Amortization of discount on estimated prize liability	\$ 21,481	\$ 12,626
Interest on notes payable	<u>165</u>	<u>257</u>
Total interest expense	<u>\$ 21,646</u>	<u>\$ 12,883</u>

NOTE 9 - RETIREMENT PLAN

The Corporation has a defined contribution retirement plan (the Plan) which covers all full-time employees. Under the terms of the Plan, the Corporation and employees each contribute 6.2% of the employee's earned annual base salary, as defined. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan.

The Corporation also makes a contribution equal to 8% of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 9 - RETIREMENT PLAN (CONTINUED)

For 2001 and 2000, total payroll was approximately \$8,649,000 and \$8,427,000, respectively. During 2001 and 2000, the Corporation's contributions were calculated using the base salary amount for full-time employees of \$8,117,000 and \$7,616,000, respectively, for the 6.2% employer match contribution, and \$8,447,000 and \$7,941,000, respectively, for the 8% additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately \$1,130,000 and \$1,066,000 (13.6% and 13.7% of covered payroll) and employee contributions to the Plan were approximately \$506,000 and \$472,000 (6.20% of covered payroll) in 2001 and 2000, respectively.

In addition to the above defined contribution retirement plan, the Corporation's employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth of Kentucky. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship. The Commonwealth of Kentucky's Comprehensive Annual Financial reports should be referred to for further disclosures related to the deferred compensation plans.

NOTE 10 - LEASES

The Corporation has entered into operating leases for the rental of office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

<u>Year Ending June 30,</u>	
2002	\$ 238
2003	128
2004	87
Thereafter	<u>14</u>
Total	<u>\$ 467</u>

Rental expense for 2001 and 2000 was approximately \$279,000 and \$272,000, respectively.

NOTE 11 – DIVIDENDS PAID

Dividends paid for the years ended June 30, 2001 and 2000 are summarized as follows (in thousands):

	<u>2001</u>	<u>2000</u>
General fund	\$ 154,000	\$ 159,330
Affordable housing trust fund	<u>5,145</u>	<u>2,875</u>
	<u>\$ 159,145</u>	<u>\$ 162,205</u>

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2001 AND 2000

NOTE 11 – DIVIDENDS PAID (CONTINUED)

Dividends paid to the general fund for the years ended June 30, 2001 and 2000 included approximately \$74,000,000 and \$25,000,000, respectively, that were required by KRS 154A.130(4)(b) to be credited from the general fund to the Collaborative Center for Literacy Development, the Early Reading Incentive Fund, the Wallace G. Wilkinson Educational Excellence Scholarship Fund, the College Access Program and the Kentucky Tuition Grants Program.

NOTE 12 - INSURANCE

The Corporation is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Corporation has purchased commercial insurance to cover these risks except for the asset value of certain gaming equipment located at retail establishments in which the Corporation retains risk of loss. As of June 30, 2001, there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years. It is also the policy of the Corporation to purchase a portion of the medical insurance needed to cover its employees.

NOTE 13 - INTERNAL REVENUE CODE SECTION 451(H)

As part of the Omnibus Consolidated and Emergency Supplemental Appropriations Bill for Fiscal Year 1999, Congress changed the rules under which certain lottery prizes are taxed. The changes to Section 451(h) of the Internal Revenue Code became effective on October 21, 1998. A transition rule provision exists that allows pre-October 22, 1998 winners, if there is an option, to elect a single cash payment of the remaining value of their prize within an 18-month period beginning July 1, 1999.

On May 3, 2000, the Corporation notified claimants of qualified prizes as defined in the Corporation's Rules and Regulations of the "special claim period" to exercise an option to receive the lump-sum cash value equivalency of their remaining annuitized prizes. The claim period is available through December 29, 2000 to the eligible winners. There were 189 prize winners eligible for this option as of the date of notification. During the year ending June 30, 2000, 38 winners exercised their option and were paid the single cash payment option. The fair market value of investments sold to meet these obligations was \$24,534,602 and grand prizes payable were reduced by \$19,570,811. The Corporation recorded a loss of \$4,964,000 on these single cash payments in fiscal year 2000. During the year ending June 30, 2001, an additional 44 winners exercised their option and were paid the single cash payment option. The fair market value of investments sold to meet these obligations was \$56,505,238 and grand prizes payable were reduced by \$48,888,856. The Corporation recorded a loss of approximately \$7,616,000 on these single cash payments in fiscal year 2001.

NOTE 14 - IMPACT OF NEW ACCOUNTING STANDARDS

In June of 1999, the Governmental Accounting Standards Board issued GASB Statement No. 34, "Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments." This statement is effective for financial statements for fiscal years beginning after June 15, 2001. Management has not yet assessed the impact that the adoption of GASB No. 34 will have on the Corporation's financial statements.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER  
FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN  
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Auditor of Public Accounts, Commonwealth of Kentucky and  
the Board of Directors, Kentucky Lottery Corporation

We have audited the financial statements of the Kentucky Lottery Corporation (the Corporation) as of and for the year ended June 30, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Corporation's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management of the Corporation and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.



POTTER & COMPANY, LLP  
August 10, 2001

KENTUCKY LOTTERY CORPORATION  
SCHEDULE OF FINDINGS  
Year Ended June 30, 2001

Schedule of auditor's results

We have issued an unqualified opinion, dated August 10, 2001, on the financial statements of the Kentucky Lottery Corporation as of and for the year ended June 30, 2001.

Our audit disclosed no instances of noncompliance which are material to the Kentucky Lottery Corporation's financial statements.

Findings relating to the financial statements

Our audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

THIS PAGE LEFT BLANK INTENTIONALLY

KENTUCKY LOTTERY CORPORATION  
SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS  
Year Ended June 30, 2000

The prior year's audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.